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IN THE

CHARLES E. MORSE

Supreme Court of the United States

OCTOBER TERM, 1950.

No. 461

IN THE MATTER OF

FEDERAL FACILITIES REALTY TRUST, A COMMON
LAW TRUST, AND NATIONAL REALTY TRUST, A
COMMON LAW TRUST,

DEBTORS.

STACY C. MOSSER, SUCCESSOR TRUSTEE OF NATIONAL
REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST, AND
JOHN W. GUILD, INDENTURE TRUSTEE, ETC.,

Petitioners,

vs.

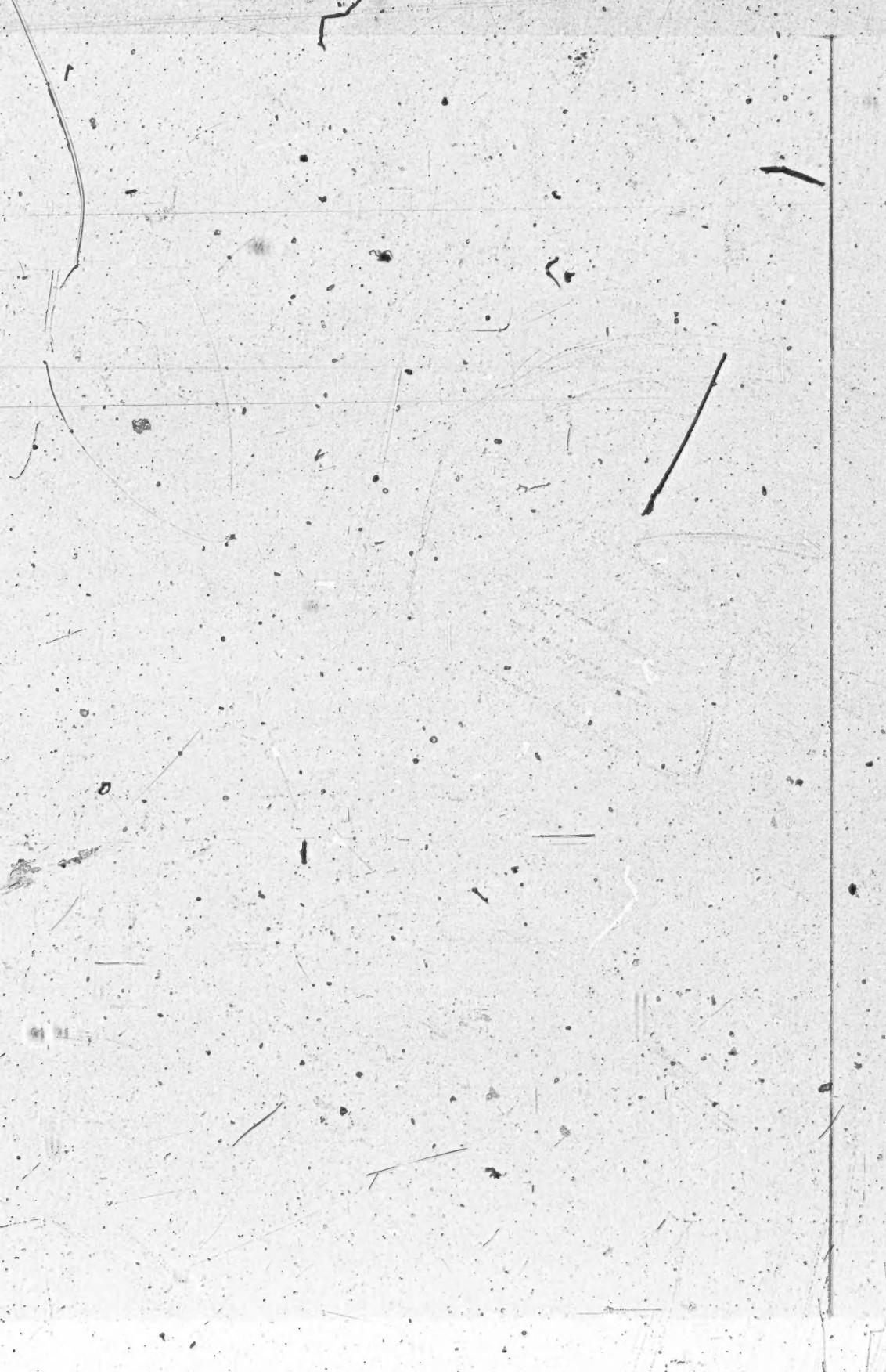
PAUL E. DARROW, FORMER TRUSTEE OF NATIONAL REALTY
TRUST AND FEDERAL FACILITIES REALTY TRUST,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SEVENTH CIRCUIT, AND BRIEF IN SUPPORT
THEREOF.

CARL W. MULFINGER,
J. EDGAR KELLY,
JACOB B. COURSHON,
Counsel for Petitioners.

STANLEY A. KAPLAN,
Of Counsel.



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COMMON LAW TRUST,

DEBTORS.

STACY C. MOSSER, SUCCESSOR TRUSTEE, ET AL.,
Petitioners,

vs.

PAUL E. DARROW, FORMER TRUSTEE,
Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable Justices of the Supreme Court of the
United States:

The petition of Stacy C. Messer, successor trustee of Federal Facilities Realty Trust and National Realty Trust, two common law trusts, and John W. Guild, trustee under the indenture securing the collateral trust bonds of Federal Facilities Realty Trust, for writ of certiorari to the Court of Appeals for the Seventh Circuit in the above entitled cause, respectfully shows to this Honorable Court:

I.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

These petitioners filed objections to the final accounts of Paul E. Darrow, the former trustee of Federal Facilities Realty Trust and National Realty Trust, in the proceedings for the reorganization of each of said trusts. Objections were also filed by the Securities and Exchange Commission. The proceedings for the reorganization of both Federal Facilities Realty Trust and National Realty Trust were filed in December, 1934, and, upon approval of the petitions, Paul E. Darrow was appointed trustee of each trust, which position he held until he resigned on August 10, 1943, and Stacy C. Mosser was appointed as successor trustee of each debtor.

The final accounts of the former trustee, and the objections thereto, were referred by the District Court to a special master. The report of the special master sustained the objections to the trustee's accounts insofar as they sought to surcharge the trustee with profits made by two of his employees who were permitted to trade in trust securities consisting of bonds issued by the subsidiary corporations of the debtor trusts. The profits so made by these employees aggregated \$43,447.46.

The report of the special master was approved by the District Court and the former trustee surcharged with said profits; a ruling on all other objections to the trustee's accounts was reserved pending further proceedings. From this order of the District Court, the former trustee appealed, and the Court of Appeals for the Seventh Circuit reversed the order of the District Court insofar as it surcharged Darrow with the profits made by his employees; in all other respects the order was affirmed.

Trust, the debtors, are common law trusts which were created by declarations of trust dated, respectively, September 10, 1929, and July 2, 1930. The original trustees of each trust were Jacob Kulp, Lee H. Kulp, and Myrtle Johnson. In the 1920's, Jacob Kulp and Company, Inc. (now bankrupt) organized, promoted and controlled twenty-six building corporations, the properties of most of which were leased to the United States Government for post office use. The buildings were financed by the sale of bonds to the public, while all the capital stock in each instance was issued to Jacob Kulp. In addition, Jacob Kulp owned in fee certain premises in Los Angeles upon which a building was constructed for post office use. The twenty-seven properties were subject to large issues of first mortgage bonds and, in many instances, subject to second mortgages as well. Confronted with cancellations, modifications of leases, and a decrease in rentals, the promoters established these common law trusts and attempted to persuade the holders of bonds of subsidiaries to exchange their securities for bonds or certificates of beneficial interests of the trusts. All of the capital stock of fourteen of the building corporations was transferred by Kulp to Federal Facilities Realty Trust in exchange for one hundred thousand shares of beneficial interest and three hundred thousand dollars, face value, collateral trust bonds issued by said trust. All of the stock of twelve of the building corporations, plus the fee in the Los Angeles property, was transferred by Kulp to National Realty Trust in exchange for twenty thousand shares of beneficial interest (R. 159, 181).

The evidence presented to sustain the objections to Darrow's accounts disclosed that after his appointment as trustee, he occupied the former offices of the trusts and employed Jacob Kulp and Myrtle Johnson to assist him in his duties. They were familiar with the business, hay-

ing been in control of these trusts and corporations since their creation. Jacob Kulp was employed to manage the buildings owned by the subsidiary corporations of each trust, and had access to the books and records of the trusts and their subsidiaries. Myrtle Johnson's duties were numerous. She had complete supervision of the trustee's office, access to all books and records, acted in behalf of the trustee when bondholders came to his office or made inquiry by telephone, advised the trustee on all phases of management, assisted him in the reorganization of the subsidiary corporations, and in determining the prices the trusts or the subsidiary corporations should pay for bonds (R. 188, 199-200, 202, 203, 206). While so employed, Kulp received a salary of three hundred dollars per month plus the use of an apartment (R. 182), and Miss Johnson was paid two hundred fifty dollars per month (R. 169).

Jacob Kulp and Company and Colonial Securities Company, two corporations wholly owned and controlled by Jacob Kulp and Myrtle Johnson and members of the Kulp family, occupied the same or adjoining offices with the trustee. For most of the time in question this joint office had two entrances, one marked Colonial and the other with the name of the debtor trusts, both opening into one large room. Darrow and Colonial were listed under one telephone number and their books kept by an employee of the trustee. Miss Johnson, although allegedly rendering some services to Kulp and Company and Colonial, occupied a private office in the portion of the suite occupied by the trustee. Bondholders coming to the office of the trustee were usually referred to Miss Johnson (R. 150-152, 200-202).

While so employed, Miss Johnson and Kulp, individually, and in the name of Colonial Securities Company, intercepted and purchased bonds brought into the trustee's office by bondholders seeking to sell them. Miss Johnson

and Kulp would purchase these bonds for less than Darrow was paying, and then sell them to Darrow or some outside investor at a profit. Darrow at all times had knowledge of these dealings and made no objection to them; in fact, he encouraged these activities during virtually the entire period of his trusteeship by following the practice of purchasing such bonds for the account of his trusts (R. 188). The total profits thus made by these employees were determined to amount to \$43,447.46. These are the profits which the District Court surcharged against Darrow.

II.

STATEMENT AS TO JURISDICTION.

1. Jurisdiction of this Court to review this case is based upon Section 1254 of the Judicial Code, as revised by the Act of June 25, 1948, (28 U. S. C. 1254), and Section 24 of the Bankruptcy Act, as amended by the Act of June 22, 1938 (11 U. S. C. 47).
2. The decision of the Court of Appeals for the Seventh Circuit was rendered August 14, 1950 and petition for rehearing denied September 21, 1950.

III.

THE QUESTION PRESENTED.

The question presented is whether a trustee in a reorganization proceeding should be surcharged for knowingly permitting his confidential employees, who likewise were fiduciaries, to realize profits from the purchase and sale of securities of his trust.

IV.

REASONS RELIED ON FOR ALLOWANCE OF WRIT:

1. The Court of Appeals for the Seventh Circuit has in this case decided an important question of federal law applicable to the administration of bankruptcy proceedings which has not been, but should be, settled by this Court.

2. The Court of Appeals has in this case rendered a decision in conflict with the decision of the Court of Appeals for the Sixth Circuit in *Carson, Pirie, Scott & Co. v. Turner*, 61 F. (2d) 693 (1932).

3. The Court of Appeals has determined in this case that the decision in the case of *Carson, Pirie, Scott & Co. v. Turner* is not applicable to the factual situation presented here, and if that is true, there is no decision by this Court, or any other court, which settles or determines the law on this vital and important issue.

4. The decision of the Court of Appeals, if permitted to stand, will result in a serious impact against, and a diminution of, the high standard of ethics necessarily required in the important and ever-widening field of reorganization proceedings and fiduciary obligations.

WHEREFORE, your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Court of Appeals for the Seventh Circuit, commanding that Court to certify and send to this Court for its review and determination, on a day certain to be therein designated, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket, "No. 9935, In the Matter of Federal Facilities Realty Trust, a common law trust, and National Realty Trust, a common law trust, Debtors; Paul E. Darrow, Former Trustee, Appellant vs. Stacy C. Mosser, Successor Trustee,

et al., Appellees', and that said judgment of the Court may be reversed by this Honorable Court; and that your petitioners may have such other and further relief in the premises as to this Honorable Court may seem meet and just. And your petitioners will ever pray.

STACY C. MOSSER, Successor Trustee
of Federal Facilities Realty Trust
and National Realty Trust, Debtors,
By CARL W. MULFINGER,
J. EDGAR KELLY,
Counsel for Petitioner.

STANLEY A. KAPLAN,
Of Counsel.

JOHN W. GUHD, Indenture Trustee,
By JACOB B. COURSHON,
Counsel for Petitioner.

IN THE

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OCTOBER TERM, 1950.

No. _____

IN THE MATTER OF

FEDERAL FACILITIES REALTY TRUST, A COMMON
LAW TRUST, AND NATIONAL REALTY TRUST, A
COMMON LAW TRUST,

DEBTORS

STACY C. MOSSER, SUCCESSOR TRUSTEE, ET AL.,
Petitioners,

vs.

PAUL E. DARROW, FORMER TRUSTEE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

THE OPINION IN THE COURT BELOW.

The opinion in the Court of Appeals for the Seventh Circuit is reported in 184 F. (2d) 1, and appears at pages 675-691 of the Record.

II.

JURISDICTION.

1. Jurisdiction to review this case is based upon Section 1254 of the Judicial Code, as revised by the Act of June 25, 1948 (28 U. S. C. 1254), and Section 24 of the Bankruptcy Act, as amended by the Act in June 22, 1938 (11 U. S. C. 47).
2. The decision of the Court of Appeals for the Seventh Circuit was rendered August 14, 1950, and petition for rehearing denied September 21, 1950 (R. 727).

III.

STATEMENT OF THE CASE.

The "Summary Statement of The Matter Involved," contained in the petition, is a recital of such facts as are deemed necessary to apprise this court of the question involved and will not be repeated here.

IV.

SPECIFICATION OF ERRORS.

The Court of Appeals erred in the following respects:

1. In holding that a trustee should not be surcharged for profits made by his employees who were permitted to deal in securities of his trust if he was not derelict in hiring them in the first instance.
2. In holding that a trustee should not be surcharged for profits made by his employees who were permitted to deal in securities of his trust, if the trustee himself made no profit therefrom.
3. In holding that a trustee should not be surcharged for profits he permitted his employees to make from the sale of such securities to him.
4. In holding that a trustee should not be surcharged for profits be permitted his employees to make from the

sale of such securities to him, providing he paid no more than the "market price."

5. In holding that a trustee should not be surcharged for profits he permitted his employees to make from sales of such securities to him if the securities increased in value after he acquired them.

6. In holding that Darrow acted with the care of an ordinarily prudent man in the management of his own property.

7. In failing to find that Darrow was negligent and derelict in his duty to properly supervise the conduct of his employees.

8. In failing to find that Darrow was negligent in failing to take action to recover the illegal profits made by his employees.

9. In failing to find that the trust estates suffered losses.

10. In reversing the order of the District Court insofar as it surcharged Darrow with the profits made by his employees.

11. In reversing findings of fact of the special master, concurred in by the District Court, without a showing that such findings were clearly erroneous.

SUMMARY OF ARGUMENT.

1. The decision of the Court of Appeals is in direct conflict with the decision of the Court of Appeals for the Sixth Circuit in the case of *Carson, Pirie, Scott & Co. v. Turner*, 61 F. (2d) 693.
2. The Court of Appeals in this decision has set aside the concurrent findings of fact of the special master and the District Judge, without finding them to be clearly erroneous.
3. A trustee who permits his confidential employees to trade in the securities of his trust violates his fiduciary duty and should be surcharged for the profits realized by such employees.

ARGUMENT.

Point I.

The Decision of the Court of Appeals Is in Direct Conflict With the Decision of the Court of Appeals for the Sixth Circuit in the Case of *Carson, Pirie, Scott & Co. v. Turner*, 61 F. (2d) 693.

It is not disputed that Darrow knowingly permitted his confidential employees to deal in the securities of his trust at a profit to themselves, but the Court of Appeals has held he was not guilty of a breach of trust in so doing. Under the law as established by the Court of Appeals for the Sixth Circuit, a trustee may be surcharged for the value of goods taken by his employee if he knew, or by the exercise of reasonable diligence could have known, of the defalcations.

In *Carson, Pirie, Scott & Co. v. Turner*, 61 F. (2d) 693 (C. C. A. 6, 1932), one Paul, an auctioneer employed by a trustee in bankruptcy, misappropriated considerable merchandise over a period of time. On the theory that the defalcations were made possible by the negligence of the trustee, the opinion directed that the compensation paid Paul be disallowed in the trustee's account and that the trustee be surcharged with the value of the goods taken so far as ascertainable.

In that case, the court stated at page 694:

"The proper administration of the bankrupt's estate in the interest of creditors required that the trustee exercise reasonable diligence in the performance of his duties. Had he done so, it is inconceivable that he would not have learned of the practices of Paul in appropriating to his own use much of the most valuable merchandise. When evidence of that circumstance

was placed in his hands, he inexcusably failed to act. In spite of this, the referee found that he had discharged his duties faithfully and approved his accounts, allowing the man who had misapplied a part of the assets a large fee for his services and allowing the trustee, who negligently failed to perform his duties, the maximum amount authorized under the acts relating to bankruptcy. We find nothing in the record to support the referee's finding that the trustee faithfully performed his duty, and we hold, as a matter of law, that the order approving his accounts based upon such finding is erroneous."

The Court of Appeals in the case at bar stated in its opinion that the Securities & Exchange Commission cited "no case which supports, or even tends to support, the surcharges made against Darrow," and that the successor trustee cited no authority to sustain the statement that a trustee should be surcharged for allowing his employees to make profits which he could not himself make in equity (R. 689-90). The Carson, Pirie, Scott case was cited to the Court of Appeals, and if it is not applicable to the instant case, then there is no decision by this, or any other court, which settles the law on this issue. We submit, however, that the decision in the Carson, Pirie, Scott case is applicable and that the decision in this case is in conflict therewith.

Point II.

The Court of Appeals in This Decision Has Set Aside Concurrent Findings of Fact of the Special Master and the District Judge Without Finding Them to Be Clearly Erroneous.

In the decision in this case, the Court of Appeals has reversed findings of fact made by the special master and concurred in by the District Court, without showing such

findings to be clearly erroneous. The special master found that:

"A trustee cannot be said to have exercised due care where he knowingly allows his employees to work for him under conditions where their loyalties must necessarily be divided.

"(1) In this respect, Mr. Darrow was clearly derelict in entering into an agreement with Miss Johnson and Mr. Kulp whereby they were granted permission to continue their securities business, which, as he surely must have known, dealt extensively in the securities of the trusts and their subsidiaries. A reasonably careful and prudent man could hardly fail to recognize the obvious fact that a situation wherein the trusts and their subsidiaries were attempting to retire their indebtedness as rapidly and as inexpensively as possible, and wherein the employees of the trusts were trafficking in the bonds of the subsidiaries for profit was pregnant with potential conflicts of interest.",

and further:

"It is clear that Mr. Darrow failed to take any action at all upon discovering that his employees were dealing in the underlying securities for profit. On the contrary, the record indicates that he not only acquiesced in such activity and permitted disloyalty to flourish, but also knowingly purchased securities from them and thereby allowed their infidelity to inflict direct financial loss upon the trusts in many instances." (R. 553-554.)

The Courts of Appeals reversed this finding in the following words:

"If after such employment Darrow was obliged to exercise 'the care of an ordinarily prudent man in the management of his own property,' it is difficult to see why he should be surcharged under the facts disclosed in this case. His supervision of the trust estate would disclose that the debtor trusts were being largely benefitted by the fact that he was enabled to purchase from

such part time employees at market prices, the securities of their subsidiaries." (R. 685.)

By its action, the Court of Appeals has ignored the well-established principle that concurrent findings of fact by a special master and District Judge will not be set aside on appeal except for clear mistake or unless the record discloses them to be clearly erroneous (*Crawford v. Neal*, 144 U. S. 585; *In re Willoughby*, 95 F. (2d) 932; *Boyce v. Chemical Plastics, Inc.*, 175 F. (2d) 839; *Crimmins v. Woodson*, 177 F. (2d) 788; Rule 52 (a) of Federal Rules of Civil Procedure).

The necessary requisites for setting aside findings of fact are not present in the instant case.

We, therefore, respectfully submit that it was error for the Court of Appeals to reverse the aforesaid findings of the master concurred in by the District Court.

Point III.

A Trustee Who Permits His Employees to Trade in the Securities of His Trust Violates His Fiduciary Duty and Should Be Surcharged for the Profits Realized by Such Employees.

Petitioners' contention, that the former trustee should be surcharged for profits he permitted his employees to make by trading in securities of his trusts, is predicated upon the proposition that Miss Johnson and Kulp were trusted employees in strategic positions and, therefore, owed to their employer and the trusts the duties of fiduciaries. When these employees traded in the securities associated with the debtor trusts, they reached that fiduciary duty, and because the trustee had knowledge of and acquiesced in the acts of his employees, he became liable to the surcharge.

Thus, two confidential and trusted employees of a trustee appointed by a federal court were permitted to deal in securities of his trusts in their own names and, at times, in the name of a corporation controlled by them and which they operated from the same office as that occupied by the trustee. Colonial Securities Company was not a corporate fiction used to conceal trading transactions from the trustee; he knew it was buying and selling securities of the trusts (R. 203).

Darrow had full knowledge that his employees were dealing in the securities, and it is not contended that any of the facts were concealed from, or unknown to, him. These trading transactions fell into three definite patterns. (1) the employees intercepted and purchased bonds which were brought to the office of the trustee for sale, paying prices lower than those which they knew the trustee would pay, and resold them to the trustee the same day, or a short time thereafter, at the trustee's higher price (R. 296); (2) the employees, after purchasing the bonds from parties bringing them to the office of the trustee, sold them elsewhere at a profit (R. 275); and (3) the employees used trust funds obtained from Darrow to purchase securities at prices far below those being paid by the trustee for the same securities, and then delivered to the trustee a portion of the bonds at the prices he was paying to outsiders to absorb the trust money so advanced and sold the remaining securities elsewhere at a substantial profit to themselves (R. 171-5, 205, 431).

The facts in this case created an intense fiduciary relationship on the part of Kulp and Miss Johnson, requiring fidelity of the highest order. The trust estates had the right to command the undivided fealty of Miss Johnson and Kulp (*Fleishhacker v. Blum*, 109 F. (2d) 543 (C. C. A. 9, 1940). With all confidential information either in their possession or available to them, and with operational and

administrative problems entrusted to their care, Miss Johnson and Kulp were subject to the stringent duties of fiduciaries; as stated in *Trice v. Comstock*, 121 F. 620 (C. C. A. 8, 1903), at page 623:

*** * every relation in which the duty of fidelity to each other is imposed upon parties by the established rules of law is a relation of trust and confidence. The relation of trustee and cestui que trust, principal and agent, client and attorney, employer and an employee, who through the employment gains either an interest in or a knowledge of the property or business of his master, are striking and familiar illustrations of the relation. From the agreement which underlies and conditions these fiduciary relations, the law both implies a contract and imposes a duty that the servant shall be faithful to his master, the attorney to his client, the agent to his principal, the trustee to his cestui que trust, that each shall work and act with an eye single to the interest of his correlate, and that no one of them shall use the interest or knowledge which he acquires through the relation so as to defeat or hinder the other party to it in accomplishing any of the purposes for which it was created."

Under accepted equitable principles, a fiduciary is precluded from realizing a profit out of his trust position (*Magruder v. Drury*, 235 U. S. 106 (1914); *Michoud v. Girard*, 45 U. S. 503 (1846)); and this precept is applied particularly to transactions in property or securities connected with the trust (*Jackson v. Smith*, 254 U. S. 586 (1921)).

Darrow's conduct in permitting his employees to trade in the securities of the trust, and thereby violate their fiduciary obligations, was a direct violation of his fiduciary duty as trustee. Conduct such as this fits within the following language contained in *Scott The Law of Trusts* (1939 Ed.), Volume II, Section 225.1, pp. 1191-2:

"Where the trustee is himself at fault. The trustee is liable for the acts of an agent employed by him in the administration of the trust if the trustee is himself guilty of a violation of a duty to the beneficiaries. Thus where an agent does an act which, if done by the trustee would constitute a breach of trust, the trustee is liable if he directed or permitted the doing of the act. He is liable if he improperly delegates to an agent the performance of acts which he was under duty personally to perform. He is liable for the act of an agent employed by him in the administration of the trust, if he did not use reasonable care in the selection or retention of the agent. The trustee is liable for acts of the agent if the trustee has failed to exercise proper supervision over the conduct of the agent. He is liable if he unnecessarily entrusts money or securities of the trust or title deeds or other property to an agent, or permits the agent unnecessarily to retain the property, with the result that the agent misappropriates it. He is liable where the agent does an act which if done by the trustee would be in breach of trust, if the trustee approved or acquiesced in or concealed the act of the agent. The trustee is liable if the agent does an act which if done by the trustee would be in breach of trust, if he does not take proper steps to compel the agent to redress the wrong."

There is no other effective sanction available to the court, and, consequently, it is imperative that trustee Darrow be surcharged in accordance with the order of the District Court for knowingly permitting his employees to engage in improper conduct. These principles are affirmed in the *Restatement of the Law of Trusts, Vol. I, Section 225*, page 639, as follows:

"Section 225. Liability for Acts of Agents.

(1) Except as stated in Subsection (2), the trustee is not liable to the beneficiary for the acts of agents employed by him in the administration of the trust.

(2). The trustee is liable to the beneficiary for an act of such an agent which if done by the trustee,

would constitute a breach of trust, if the trustee

- (a) directs or permits the act of the agent; or
- (b) delegates to the agent the performance of acts which he was under a duty not to delegate; or
- (c) does not use reasonable care in the selection or retention of the agent; or
- (d) does not exercise proper supervision over the conduct of the agent; or
- (e) approves or acquiesces in or conceals the act of the agent; or
- (f) neglects to take proper steps to compel the agent to redress the wrong."

It is not disputed that the trustee would have been guilty of a breach of trust if he had purchased and sold securities of the trust with a resulting profit to himself. The facts in this case, therefore, bring the trustee within the rule that he will be held liable for permitting his employees to gain profits which he could not, for the following reasons:

1. He not only permitted the illegal acts of his employees but collaborated in such acts by purchasing securities from the employees at prices which resulted in profits to the employees and losses to his trust estate.
2. The trustee did not use reasonable care in the retention of these employees because he knew at all times that his employees were engaged in the acts complained of.
3. The trustee did not exercise proper supervision over the conduct of his employees. Having full knowledge of their acts, it became his duty to require them to discontinue their illegal practices.
4. The trustee approved and acquiesced in the illegal acts of his employees.
5. The trustee failed to take any steps to compel these employees to redress the wrongs done by them.

The Court of Appeals laid considerable stress on the fact that the bonds purchased by Darrow from his employees increased in value. The fact that these bonds, as well as real estate securities in general, increased in value during the years 1935 to 1943 was attributable to general economic conditions, and such enhancement cannot serve to absolve the trustee from liability for failure to carry out his fiduciary responsibilities. Such enhancement, even if it were due to Darrow's efforts, is no defense to a surcharge, because if the trustee's acts were unlawful "it makes no difference that the estate was not the loser in the transaction." *Magruder v. Drury*, 235 U. S. 106.

Further, in support of the finding that the trusts suffered no loss, the Court of Appeals found that Darrow purchased bonds from his employees at "market prices." The evidence clearly shows that "market prices" were those prices fixed by Darrow and Miss Johnson (R. 211).

In reversing the order of the District Court, the Court of Appeals has cited *In re Breger Kosher Sausage Co.*, 129 F. (2d) 62. In that case a creditor sought to surcharge a trustee for losses incurred in the operation of the bankrupt's business. A reading of the decision in that case discloses that there was no attempt made to surcharge the trustee for profits made by his employee in the operation of a sideline business, as is erroneously stated and assumed by the Court of Appeals in the opinion in the instant case (R. 688). All that the Court of Appeals for the Seventh Circuit decided in the Sausage Company case was that the evidence presented to the referee was insufficient to surcharge the trustee for losses incurred in the operation of the bankrupt's business, or to sustain the charge that he concealed an antagonistic interest to his trust. The court, therefore, refused to reverse findings of the referee.

The Court of Appeals also cited *Ex parte Belchier*, 1

Amb. 218 (27 Eng. Reprint 144); *Speight v. Gaunt*, 22 Ch. 727; *Evans v. Williams*, 276 Fed. 650; and *In re Marcus*, 2 Fed. Sup. 524. In each of these cases, the illegal acts of the agents or employees were concealed from the trustee and he was powerless to prevent the losses. However, in the instant case, the trustee had full knowledge of his employees' repeated breaches of trust and permitted them to continue. We, therefore, submit that the Court of Appeals has extended the doctrine of immunity which protects a non-negligent trustee to absolve a trustee who has knowingly permitted acts of misconduct.

The public importance of the issue involved renders it imperative that this court make it clear that a reorganization trustee will be held to "a high degree of both moral and legal responsibility" and that his obligations as a trustee must be rigorously enforced. The Court of Appeals for the Seventh Circuit in the instant case has departed from those general principles governing the obligations and responsibilities of fiduciaries as laid down by this court in the cases of *Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper v. Litton*, 308 U. S. 295; *American United Mutual Life Ins. Co. v. Avon Park*, 311 U. S. 138; and *Woods v. City National Bank & Trust Co.*, 312 U. S. 262. The District Court in the case of *In re Los Angeles Lumber Products Co.*, 46 F. Supp. 77, in following the principles laid down by this court in the above cases, said at page 91:

"All of these Supreme Court cases hold fiduciaries to strict standards of conduct, including officers, directors, controlling stockholders of corporations, bondholders committees, etc., and made it clear that the equitable powers of a bankruptcy court are sufficient to provide an appropriate remedy for violation of these standards."

If the decision of the Court of Appeals is permitted to stand, reorganization trustees will not be held to as high a standard of conduct as that which this court has fixed

for officers, directors, controlling stockholders of corporations, and bondholders' committees. This court has recognized that the high standards demanded of fiduciaries must not be lowered (*Magruder v. Drury*, 235 U. S. 106; *Manufacturers Trust Company v. Becker*, 338 U. S. 304).

The Circuit Court of Appeals has in effect held in this case that a court is powerless to deal with its appointed trustee who has not only indulged, but actively assisted his employees, in violating their fiduciary duties to the estate. This question not having been heretofore decided by this court, it is, therefore, not only important, but vitally necessary, that this court grant certiorari in this case and finally reverse the decision of the Court of Appeals and thereby preserve the "uncompromising rigidity" which "has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions" (*Meinhard v. Salmon*, 249 N. Y. 458).

CONCLUSION.

In conclusion, we respectfully submit that the decision of the Court of Appeals, if permitted to stand, will remove an effective sanction against the pernicious practice in bankruptcy reorganization proceedings of permitting confidential employees to profit in the securities involved in the reorganization. The decision of the Court of Appeals, if permitted to stand, will have a serious, widespread, and deleterious effect upon the standard of ethics and the rules and legal principles which have heretofore governed the conduct of fiduciaries in the administration of all trusts. No trustee should be permitted knowingly to allow his key employees to take improper advantage of their positions, while the trustee, to whom courts and beneficiaries look for ultimate responsibility, is absolved from blame and liability.

It is, therefore, respectfully submitted that this case is one calling for the exercise by this court of its supervisory powers and, to such end, a writ of certiorari should be granted, and this court should review the decision of the Court of Appeals for the Seventh Circuit and should finally reverse it.

Respectfully submitted,

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